

Internal Revenue Service
memorandum

INTL-0248-91

Br5:TBHughes

date: APR 1 1991

to: Timothy Korich, International Examiner

from: Robert Katcher, CC:INTL:Br5 *Robert Katcher*

subject: Allocation and Apportionment of Loss upon Expiration of
[REDACTED]'s Yen Put Options

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This responds to your request of March 11, 1991, for assistance regarding the proper allocation and apportionment of losses resulting from expiration of yen put options by the [REDACTED] for taxable years prior to the effective date of the Tax Reform Act of 1986. We understand the facts to be as follows.

In [REDACTED], a domestic corporation, decided to offer stock of its subsidiary, [REDACTED] to the public. The stock sale produced foreign source income. To avoid diminution in the amount of gain from the sale and to protect its consolidated financial statement net income, [REDACTED] purchased yen put options in the United States from U.S. banks. The options gave [REDACTED] the right, but not the obligation, to sell up to a specified number of yen at a specified rate of exchange over a specified period of time. Some of the put options expired, causing the loss of the option premiums. Since the put options were capital assets in the hands of [REDACTED], the losses were capital.

[REDACTED] allocated and apportioned the losses to U.S. source income. You believe that the losses should be allocated and apportioned to foreign source income. We think there is a strong technical argument that supports your position. However, the answer is not free from doubt because the rules for allocating losses from capital assets under the law prior to the Act are not clear. [REDACTED]'s position is not totally unreasonable. Indeed, allocating and apportioning the losses to foreign source income leaves us open to a potential whipsaw argument, i.e., treating the gains from the options as U.S. source under the title

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passage rule of § 1.861-7, while allocating and apportioning losses to foreign source income. We also believe, even if ██████████ is correct that the losses should be allocated to income arising from the put options, it may be possible to apportion the losses half to U.S. and half to foreign source income.

████████ submitted two arguments in support of its position. First, it noted that under § 1.861-7, if the disposition of the options had resulted in gains, they would have been sourced in the U.S. had title passed in the U.S. ██████████ asserts, in effect, that both gains and losses should be "sourced" under the title passage rule. Since all of the options expired within the United States, the loss should be allocated to U.S. source income. However, § 1.861-7 clearly applies only to gains, profits and income, not to losses, and thus is not applicable.

Second, ██████████ argued that its treatment is supported by § 1.861-8(e)(7)(i). That section provides, in part, that the deduction allowed for a capital loss shall be considered a deduction which is definitely related and allocable to the class of gross income to which such asset or property ordinarily gives rise in the hands of the taxpayer. Shaklee argues that since the gain on the sale of the options would have been U.S. source income under § 1.861-7, the class of gross income to which the losses are definitely related is U.S. source income.

However, § 1.861-8(e)(7)(i) apparently was intended to apply only to property or an asset that generates or could reasonably be expected to generate income while in the hands of a taxpayer. This interpretation is bolstered by the second sentence of the section that discusses what happens when the nature of the gross income generated by "the asset or property" varies over several taxable years. Furthermore, the example in § 1.861-8(e)(7)(i) regards an asset that generates two types of income, sales income and rental income. The options cannot give rise to any income while in ██████████'s hands; they only produce gain or loss upon sale, exercise, or expiration. Thus, technically § 1.861-8(e)(7)(i) may not apply to losses from the options. However, it must be noted, and the taxpayer will doubtless argue, that the regulation does not specifically state that it applies only to an asset or property that could generate income prior to a sale or other disposition.

████████'s argument concerning § 1.861-8(e)(7) has further problems. ██████████ is lumping together the functions of allocation to a class of gross income, as described in §

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1.861-8(e)(7)(i) and apportionment to foreign or U.S. source income, which is described in § 1.861-8(e)(7)(ii). Assuming that under § 1.861-8(e)(7)(i), the class of gross income to which the put options losses are allocable is income from the sale of those options, § 1.861-8(e)(7)(ii) then describes how to apportion such losses. Where in the unusual circumstances that an apportionment of a deduction for losses on the sale, exchange, or other disposition of a capital asset is necessary, the amount of such deduction shall be apportioned between the statutory grouping and the residual grouping of gross income in the same proportion that the amount of gross income within such statutory grouping and such residual grouping bear, respectively, to the total amount of gross income within the class of gross income. ████████ had no gross income from the sales of put options in ████████; its assertion that all of its put option losses should be apportioned to the residual U.S. source grouping is based upon the fact that it sold some put options in the United States in ████████. However, assuming there were no contract terms so prohibiting, in ████████ ████████ could have chosen to sell the options either inside the United States or outside, thereby generating either U.S. source or foreign source income because of the title passage rule of § 1.861-7. Based on that fact, it would seem appropriate to apportion half of the option losses to foreign source income and half to U.S. source.

If § 1.861-8(e)(7) is not applicable, the general rules in § 1.861-8 apply. Section 1.861-8(a)(2) requires a taxpayer to allocate deductions, including losses, to a class of gross income. Section 1.861-8(b)(1) emphasizes the factual relationship between the deduction and the class of gross income. Section 1.861-8(b)(2) states that a deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. This rule applies whether or not there is any item of gross income in such class. These general rules can be interpreted in ████████'s case to reach different results. While we believe that the first argument is the better of the two, you should be aware that it is not the only one.

The losses could be allocated to a class of gross income which includes income from the sale of the stock because the deduction (the put option loss) was incurred as a result of an activity (the stock sale). Since the income from the stock sale was all foreign source, the loss would be apportioned only to the statutory grouping. The fact

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that the options were purchased prior to receipt of the gross income from the stock sale does not prevent the establishment of a factual relationship between the losses and that income since the regulations speak to gross income which could reasonably have been expected to be generated from an activity.

However, the regulations under § 1.861-8(b) may be interpreted to support ████████; the losses were incurred in connection with property (the put options) which generates or could reasonably have been expected to generate gross income. Having found the class of gross income to which such losses are allocable, it is then necessary to apportion such losses. Under § 1.861-8(c)(1), where deductions are definitely related to a class of gross income and such income is included in one or more statutory groupings and a residual grouping, the deductions must be apportioned to the statutory grouping(s) and the residual grouping. No apportionment is necessary if a class of gross income is within a single statutory grouping or the residual grouping. In ████████'s case, the statutory grouping for purposes of section 904 is foreign source income and the residual grouping is U.S. source income. If the losses are allocated to the put option income, under § 1.861-8(c)(1), deductions are apportioned by attributing them to one or more statutory grouping and the residual grouping. The attribution must reflect "to a reasonably close extent" the "factual relationship" between the deduction and the gross income grouping. Although "to a reasonably close extent" or "factual relationship" are not defined terms, the regulations provide examples of "bases and factors" that are to be considered in making the apportionment. One example of the bases and factors that can be used for apportioning deductions is gross income. For the same reasons that were argued above concerning apportionment under § 1.861-8(e)(7)(ii), it would seem appropriate to apportion half of the option losses to foreign source income and half to U.S. source.

Please feel free to call Terry Hughes (FTS 566-6284) if you have any additional questions.

cc: Bill Bonano, International Special Trial Attorney

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